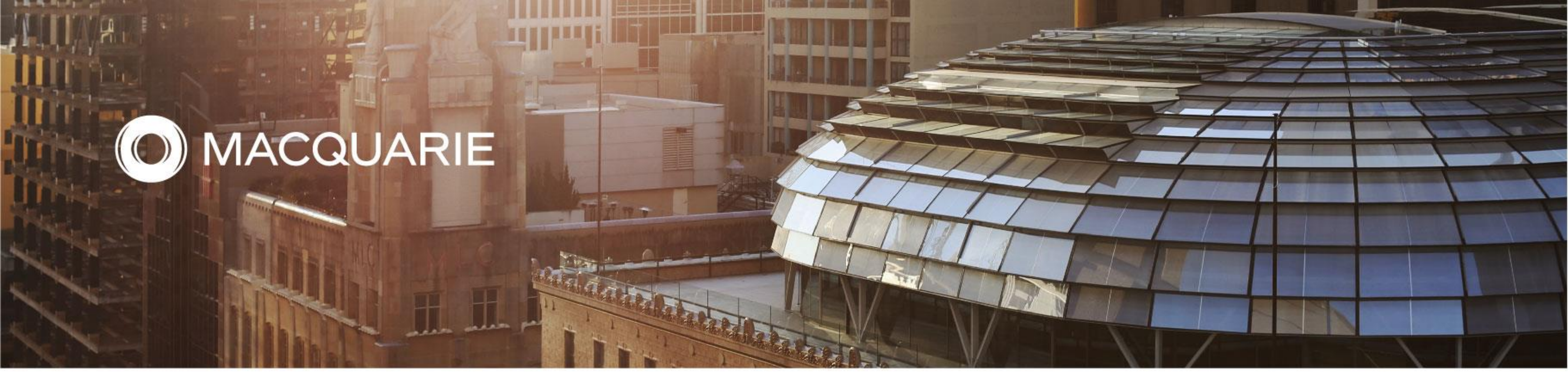


# Investment Strategy Update #103

## US inflation shock(er) pushes equities into bear market

- Last Friday's US inflation print was a shocker and showed that both bonds and equities are still vulnerable to further inflation and rates disappointment. A new peak and broadening inflation pressures suggest a sharp 2H decline might be optimistic and that the Fed may need to go much harder on raising rates. Neither is a good outcome for bonds or equities.

- The sell-off in US equities (22%) is already larger than the average "non-recession" correction period (16%). However, the US market has not yet given back all the gains made through the COVID period and given they were fuelled by unsustainably low rates and excess liquidity, we think this will happen.

- Traditionally, interest rates pop valuations bubbles and growth shocks pop earnings bubbles. At present, rates are popping a valuation bubble, but a growth shock is still a 2H23 event according to Macquarie's Macro Team. Nevertheless, economic growth is decelerating, and profit growth has peaked, meaning equity fundamental are weakening even if inflation & rates developments become more positive.

- While Australia is running a slightly different race, we think the US is a reasonable roadmap for domestic developments. Domestically, inflation has not peaked, financial conditions are still tightening, the consumer is stretched, equities are not cheap and corporate are facing strong costs pressures. Equity fundamentals are likely to get weaker from here and this raises further near-term downside risk.

- For some time, we have invested on the basis of slowing growth, rising rates, elevated inflation and ongoing volatility. The motto of "buying the dips" was in place because central banks were the backstop for every shock or equity sell-off. They are no longer the backstop and if fundamentals are softening and central banks are tightening, the tailwinds are fading.

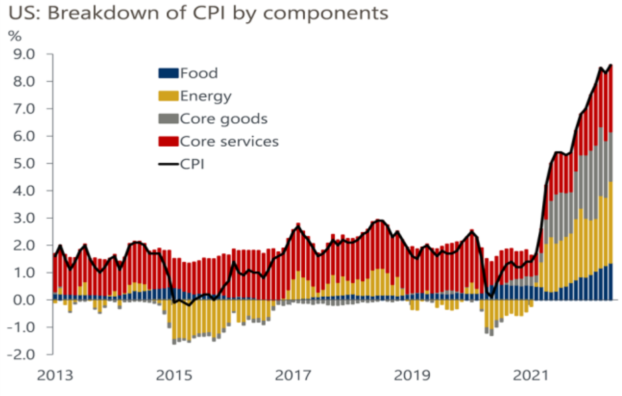
- Investors should be prepared for more of the same in coming months. Inflation is key to where rates go and where rates go is key for equities. We continued to reduce risk in our May Investment Matters report and continue to use non correlated assets as our key portfolio diversifying agent.

## US inflation continues to rise

Friday's US inflation print was a shocker coming in at 8.6% yoy (up from 8.3% in April). It was thought that inflation had already peaked but the May release showed broad based pressures across both core goods and services as well as energy and food were in fact still rising due to a confluence of factors including ongoing supply chain disruptions, a tight labour market, rising gasoline and food prices and solid consumer demand.

As a result, bond yields spiked sharply (across the entire curve) and equities sold off heavily (with growth stocks suffering the largest declines). This was an extremely disappointing print for market watches (including ourselves) as it put an end to the stabilization / recovery that had been underway in bond yields and risk assets since mid-May.

US Inflation rises to a fresh peak

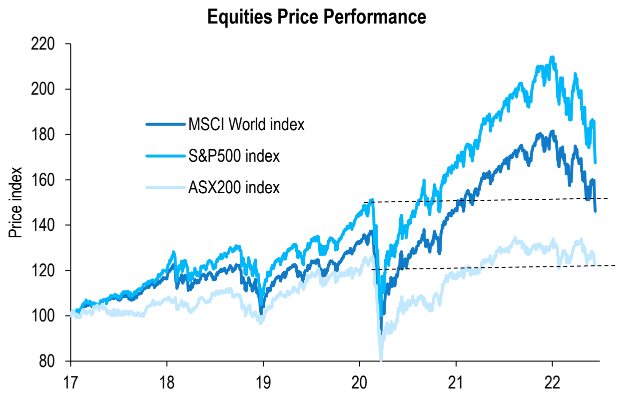



Source: Oxford Economics, June 2022

The takeaway is that inflation might bob around the high 8's for a while longer, but more importantly, the decline is probably going to be more gradual through 2H given headline figures are still rising and supply chain disruptions are not disappearing quickly.

We think it is getting increasingly difficult to see how equity markets can move sustainable higher without a rapid decline in inflation that would release some of the pressure on the Fed and other central banks to raise policy rates. This is because equities are now battling numerous headwinds including a deceleration in economic growth, peaking profit margins, rising interest rates and shrinking liquidity. If the inflation handcuffs are removed, then we think the economic growth backdrop is solid enough for risk assets to keep rising even if there is no further multiple expansion and earnings growth is slowing but not negative.

US equities still have COVID gains to give back



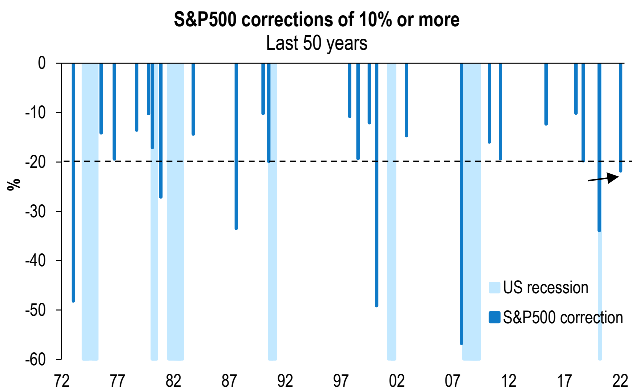

Source: FactSet, MWM Research, June 2022

## US equities are in a bear market

But without some rate (expectation) relief, then the deceleration in economic and earnings growth combined with shrinking liquidity and deteriorating confidence are sizable headwinds for the market when valuations have not reached levels that would underpin downside into further negative surprises and because markets are some way from capitulation levels.

Similarly, if the US was to fall into recession earlier than we are forecasting in 2H23, then the market correction is not yet complete even for an average short/shallow recession decline of ~30%. We don't want to react to every data point, but it is inevitable to that the market will oscillates between soft and hard landing scenarios.

US equities are now in a bear market

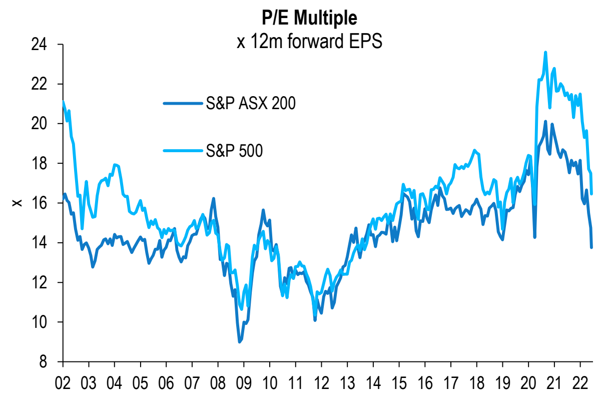



Source: FactSet, MWM Research, June 2022

From an investment perspective there are plausible paths to a soft landing and a better market outlook, but the stubbornness of inflation and the rising breadth of price pressures is making this scenario less likely. We think we are in "muddle through" period characterized by high inflation and a rapid reset of policy rates but where economic growth remains solid even though it is decelerating.

This means equities remain susceptible to inflation and rates disappointments (as Friday's sell-off would indicate), but where the economy and earnings are not in recession conditions. This means that when we do get periods of better inflation / rates developments (like from mid-May through to early last week), we can see a rebound in risk assets, but falling profit margins decelerating earnings growth and only modestly attractive valuations mean upside is relatively limited and can run out of steam quickly.

The COVID valuation bubble is disappearing fast




Source: FactSet, MWM Research, June 2022

On the other hand, if inflation does not begin to decline then the risk of a recession increases and is also brought forward from 2H23. Against this backdrop, valuations are not cheap enough and earnings have not been downgraded enough to prevent the market falling much further should it decline in line with an average recession correction. Similarly, most cyclical sectors within the equity market have not been discounted anywhere near normal recession-like levels and we would expect to see significant downside in these areas as they become infected by recession fears.

At this stage Macquarie is holding onto its 2H23 recession call and provided we are close to an inflation peak, then it is consistent with a sideways, volatile but range trading equity market. If inflation disappoints or growth risks rise, then its more likely we move towards pricing in recession like declines across both earnings and equities which would equate to another 15-20% downside for Australian equities. At best, the outlook is a lot of volatility with limited price upside. At worst, it's a lot more downside even assuming a modest recession.

**Macquarie WM Investment Strategy Team**

The report was finalised on 14 June 2022.

**Recommendation definitions (Macquarie Australia/New Zealand)**

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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